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E.O. 12958: N/A
TAGS: EFIN ECON PGOV BR
SUBJECT: BRAZIL BUYS BACK BRADY BONDS

REF: A) BRASILIA 0366 B) BRASILIA 0790

¶1. (U) Summary: The GOB exercised its option to buy back its Brady bonds on April 18. The operation involved bonds with a total face value of US$6.63 billion, and was part of Brazil's broader effort, taking advantage of the appreciated Real, to put behind it the legacy of its 1980's default. Brazil also has prepaid most of its rescheduled Paris Club debt. In a separate effort to improve its debt profile, the GoB bought back US$3.7 billion of its Global bonds, which were to mature in 2010. Repurchases of external debt since January have totaled US$10.2 billion. The GoB hopes the moves, which improve its external debt profile, will help it make its case for an eventual investment-grade sovereign credit risk rating. End Summary.

Legacy of 1980's Default

¶2. (U) The appreciated Real, the product of high dollar inflows over the last two years (ref A), has created opportunities for the GoB to improve its external debt profile and to wipe from the books the legacy of its late 1980's default. This effort, which will extend the repayment profile of Brazil's debt and reduce near-term payments, also is designed to enhance Brazil's bid for an investment-grade sovereign credit rating. The GOB has been aided in this effort by the record low spreads (as of May 9, 219 basis points) at which it has been able to borrow overseas. To buy back the Brady bonds, the GOB used US$5.7 billion of its international reserves, which stood at US$58.9 billion on May 8 (up from 18 billion in 2003). The GoB in late 2005 also prepaid its $15.5 billion debt to the IMF. According to the Finance Ministry, external government debt has now been reduced to US$65 billion, or 52.4% of expected 2006 exports. However, with stagnant GDP growth in 2005 and increased levels of domestic debt, after marked improvement in 2003/2004, the overall public sector net-debt-to-GDP ratio (both domestic and external) barely budged last year, down from 51.7% in 2004 to 51.6% in 2005.

Finance Minister: "Erases a Stain"

¶3. (U) Finance Minister Guido Mantega described the buyback as

erasing a stain from Brazil's record, declaring that "We are free from ... the debt repayment moratorium in the 80s". Local analysts tend to agree. By eliminating a reminder of Brazil's past failure to honor its repayment obligations, the Brady Bond repurchase should improve the perception of Brazil risk on international markets.

New focus: Domestic Debt and Investment Grade

¶4. (SBU) The GOB's recently-appointed Treasury Secretary, Carlos Kawall, said that the Treasury's focus will switch ever more to managing the domestic debt, with the particular goal of extending its maturity and moving away from floating rate notes to fixed rate and inflation-indexed bonds. In an aside directed at some local critics of the government's Brady buyback, Kawall remarked that the GOB expects that some of this US$6.63 billion used to repurchase this external debt will return to the Brazil in the form of investments in domestically-issued bonds. However, former Assistant Secretary of the Treasury, Jose Antonio Gragnani, has admitted it

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would be hard to calculate how much of this money would return to Brazil. Kawall stated the Treasury will now focus on the reducing the proportion of floating rate domestic debt which is indexed to the overnight benchmark rate (the SELIC) as well taking other steps to move Brazil from the necessary two notches up to investment grade. A Fitch-IBCA report noted that while the recent external debt repurchases were positive, the action does not justify an upgrade in and of itself. "There needs to be more clarity on the structural reforms and fiscal programs, this would be essential for an upgrade on Brazil" the report stated. (Note: Fitch's most recent upgrade of Brazil's sovereign rating was based primarily on the improvement in external solvency, based on Brazil's surprising export/current account performance.)

¶5. (SBU) Comment: As there will be no progress on the structural/microeconomic agenda until after this presidential election year, the GoB is limited to steps such as the Brady Bond buyback and its other debt repurchases to build its case for an investment grade credit rating. But there is only so much that clever debt management can do. Overall debt levels remain high as the GoB's external debt repurchases have, essentially, been financed with additional domestic debt. The fiscal picture remains complicated by constitutional spending earmarks and mandated transfers to states and municipalities. And with previous strong revenue growth beginning to falter (ref B), that leaves cutting current expenditures beyond what is necessary to meet the 4.25% of GDP primary surplus target as perhaps the only substantive step left for this GoB to take to build its case for investment grade. But with presidential elections looming, political scandals and a crisis with Bolivia brewing, we do no expect the current government to undertake such politically unpalatable choices. Instead, look for the GoB to kick the fiscal can down the road a year, postponing the investment grade rating along with it.

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